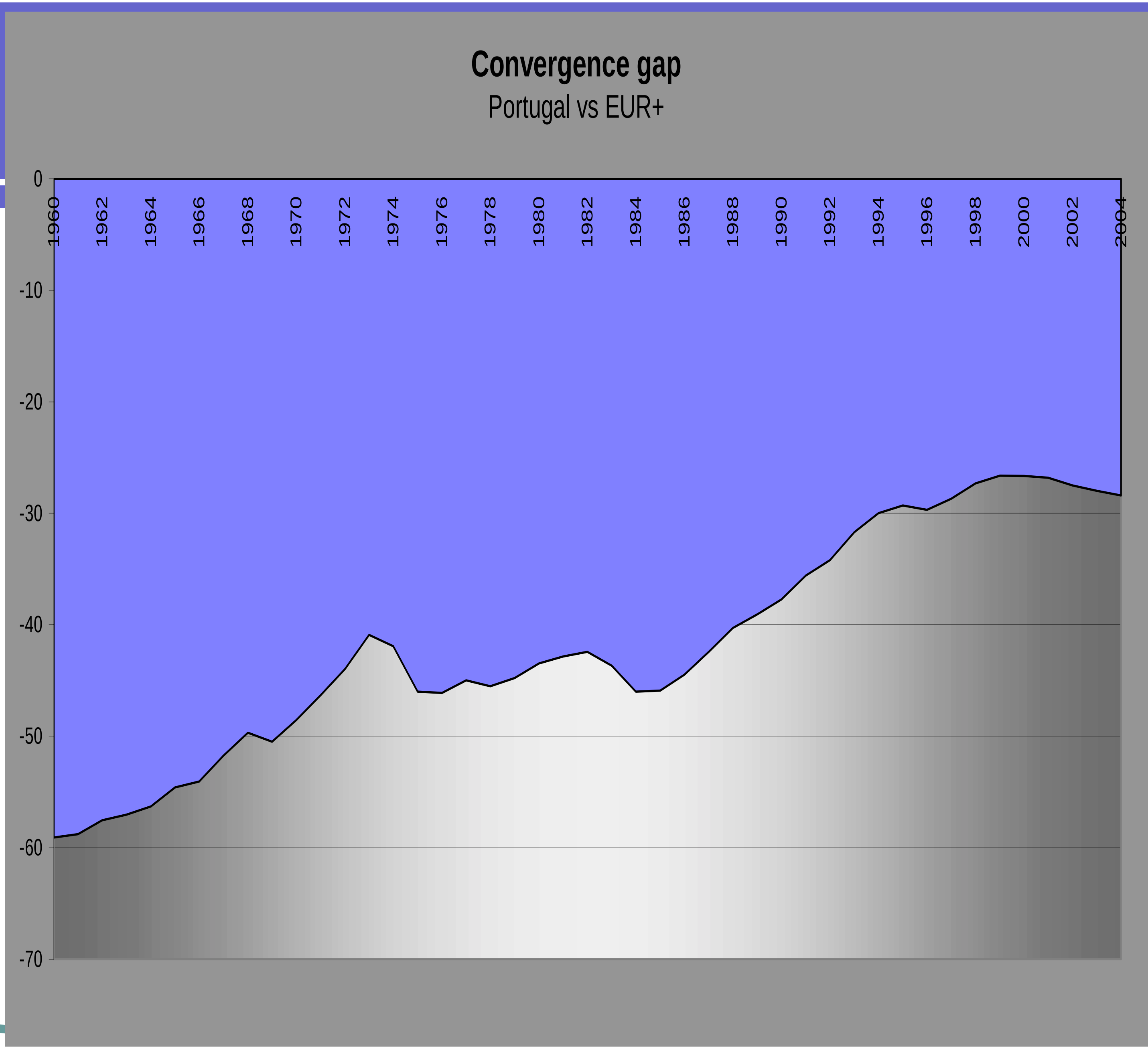
# Portugal´s convergence process: lessons for Accession Countries

Abel M. Mateus
Universidade Nova de Lisboa

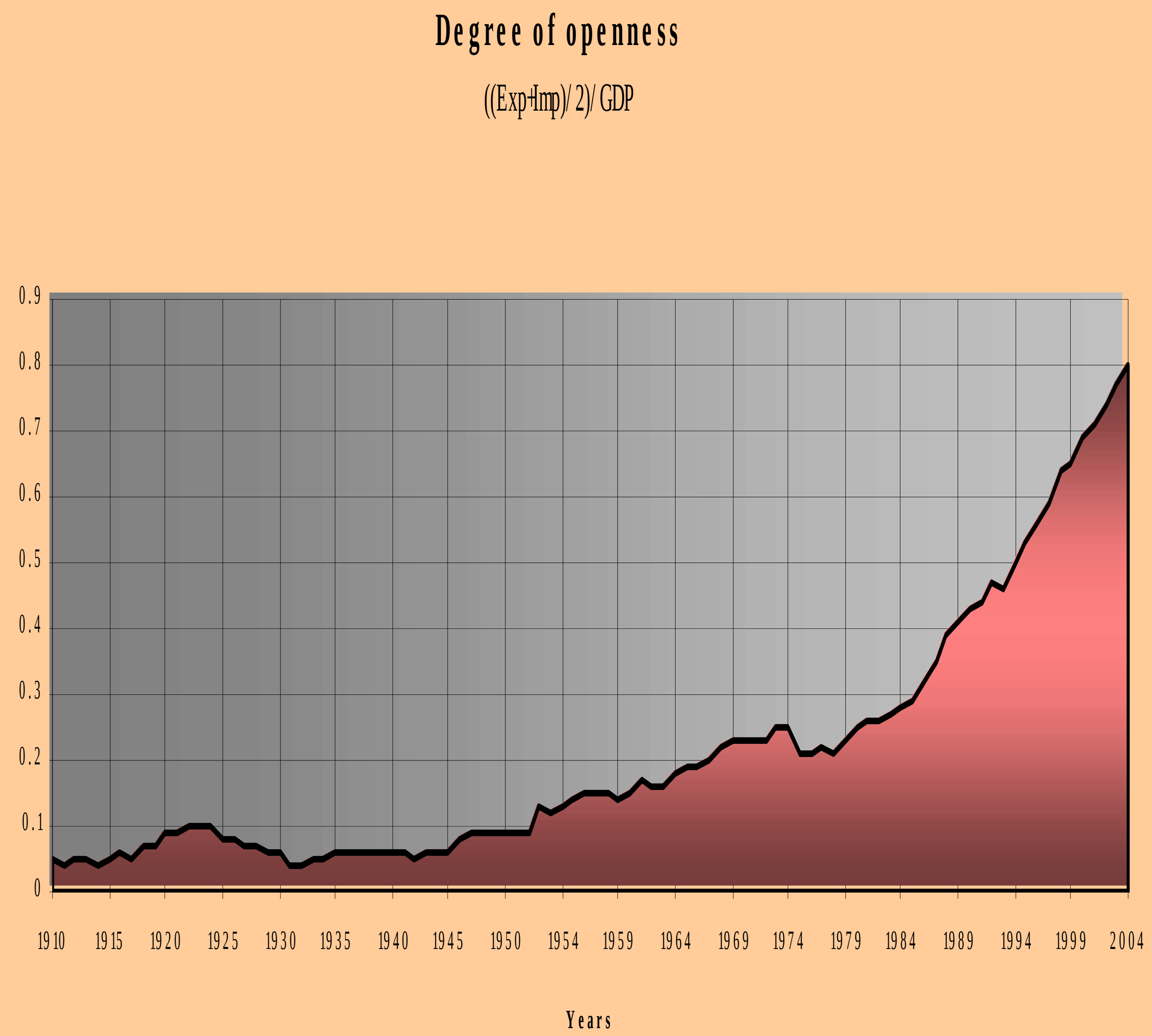
- It is widely known the success of Asian Tigers
- But is less known that Portugal was one of the few countries, similar to the Asian Tigers, that changed from a developing to a developed country in the period 1960-1990- 30 years (WB definition)
- From 1960 to 2003 the gap to the EU decreased from 57 to 27 p.p.


Convergence gap
Portugal vs EUR+
0
-10
-20
-30
-40
-50
-60
-70
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004

# Outline

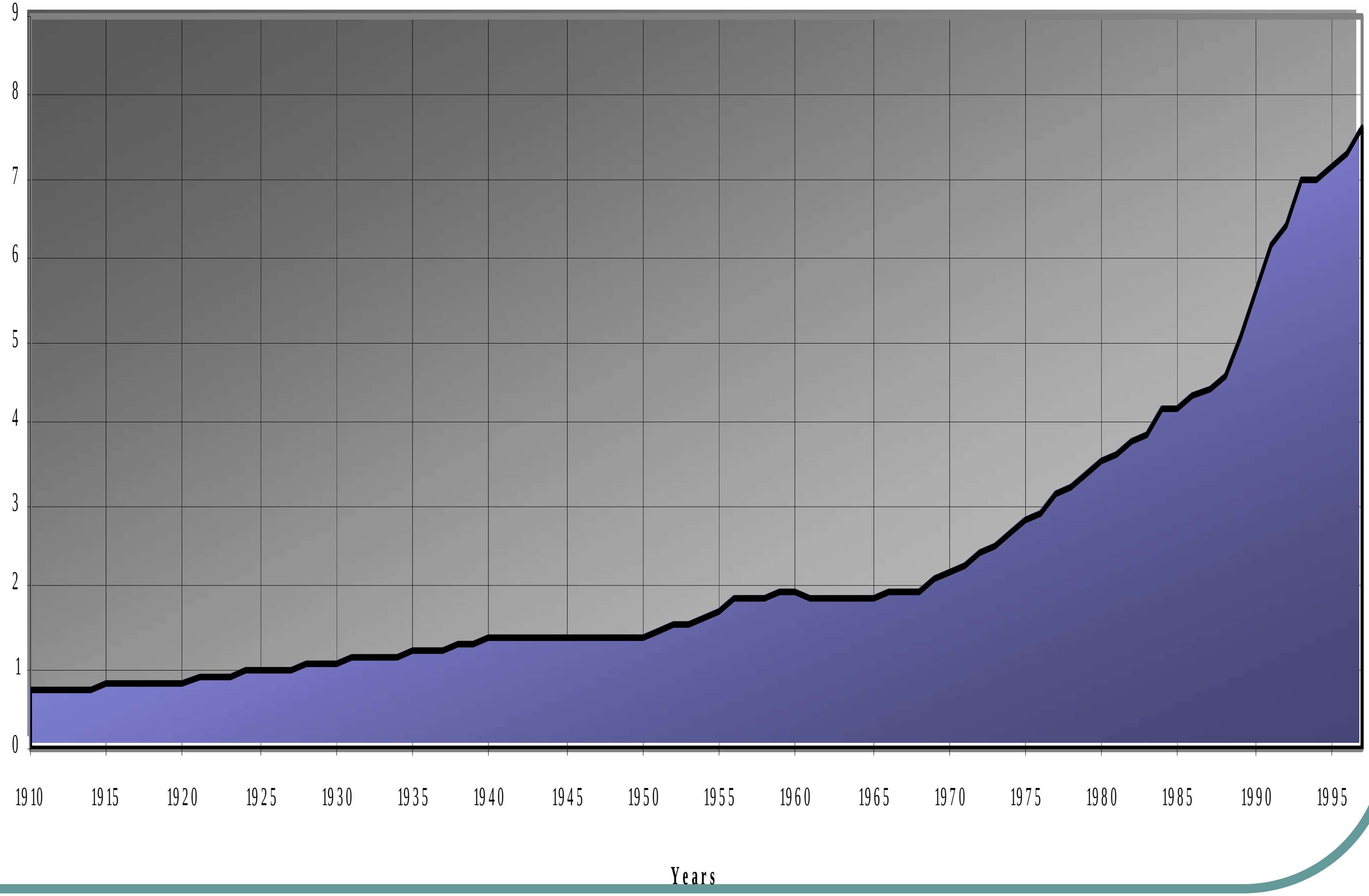
- **Factors explaining the convergence process**
- The three phases of the convergence process
  - The golden age of European integration (1960-1973)
  - The socialist-statization period (1975-1985)
  - EC accession and nominal convergence to the euro (1986-1996)
- Some econometric results with a growth model
- Good and bad lessons

- The two most important factors behind Portuguese convergence to the European levels, during the 1910-2000 period have been
  - Openning up the economy, and
  - Building-up human capital



Degree of openness
((Exp+Imp)/2)/GDP
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
1910
1915
1920
1925
1930
1935
1940
1945
1950
1954
1959
1964
1969
1974
1979
1984
1989
1994
1999
2004
Years

# Index of Human Capital



# And build up modern institutions and pursuing good economic policies

Table 1

| Year | Degree of openness | Fiscal pressure | State intervention | Macro policy | Foreign investment | Banking | Prices and wages | Property Rights | Regulation | Black Market premium |
|---|---|---|---|---|---|---|---|---|---|---|
| 1960 | 3.2 | 2.0 | 3.0 | 1.0 | 4.0 | 4.0 | 4.5 | 1.4 | 5.0 | 2.0 |
| 1965 | 2.9 | 2.0 | 2.8 | 1.5 | 4.0 | 3.0 | 3.5 | 1.4 | 5.0 | 2.0 |
| 1970 | 2.8 | 2.0 | 2.8 | 2.0 | 3.7 | 3.0 | 3.0 | 1.4 | 4.0 | 2.0 |
| 1975 | 3.0 | 2.7 | 3.7 | 3.6 | 4.0 | 3.9 | 3.7 | 4.7 | 4.0 | 3.2 |
| 1980 | 2.5 | 3.5 | 3.5 | 3.0 | 3.2 | 3.8 | 3.2 | 3.2 | 3.7 | 3.3 |
| 1985 | 2.1 | 3.7 | 3.3 | 2.7 | 3.0 | 3.7 | 3.2 | 3.0 | 3.6 | 2.7 |
| 1990 | 1.5 | 3.6 | 3.2 | 2.5 | 2.3 | 3.5 | 2.6 | 2.7 | 3.5 | 2.0 |
| 1995 | 1.3 | 3.6 | 3.0 | 2.3 | 2.5 | 3.0 | 2.0 | 2.0 | 3.2 | 2.0 |
| 2000 | 1.3 | 3.6 | 2.5 | 1.7 | 2.5 | 3.0 | 2.0 | 2.0 | 3.2 | 3.5 |

Table 2 also reports an Index of Total Factor Productivity that is based on an estimate of the Solow residual.

Table 2

| | Index EF | Development Policy | Índex EP | Index TFP |
|---|---|---|---|---|
| 1960 | 199.4 | 2.0 | 249.7 | 126.0 |
| 1965 | 219.4 | 2.0 | 259.7 | 142.1 |
| 1970 | 233.4 | 1.5 | 291.7 | 164.1 |
| 1975 | 135.0 | 3.0 | 167.5 | 183.0 |
| 1980 | 171.0 | 2.1 | 230.5 | 184.1 |
| 1985 | 190.0 | 2.0 | 245.0 | 189.4 |
| 1990 | 226.0 | 1.6 | 283.0 | 200.9 |
| 1995 | 251.0 | 2.0 | 275.5 | 206.5 |
| 2000 | 247.0 | 2.0 | 273.5 | 208.1 |

The Index of Total Factor Productivity shows the highest jumps in the 15-year period from 1960 to 1974, at an annual growth rate of 3.8%.

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# The golden age (1960-1973)

- Portugal becomes an EFTA member in 1960, and exports start to grow at 19% per annum, up to 1972
- Development policy orientation: from import substitution to export promotion
- Shift from a system of control of private investments to more free competition
- Strong investment both in physical and human capital
- Macroeconomic policy: balanced budget, low inflation, and stable foreign exchange; build-up of foreign exchange reserves to a record high

# The socialist-statization period

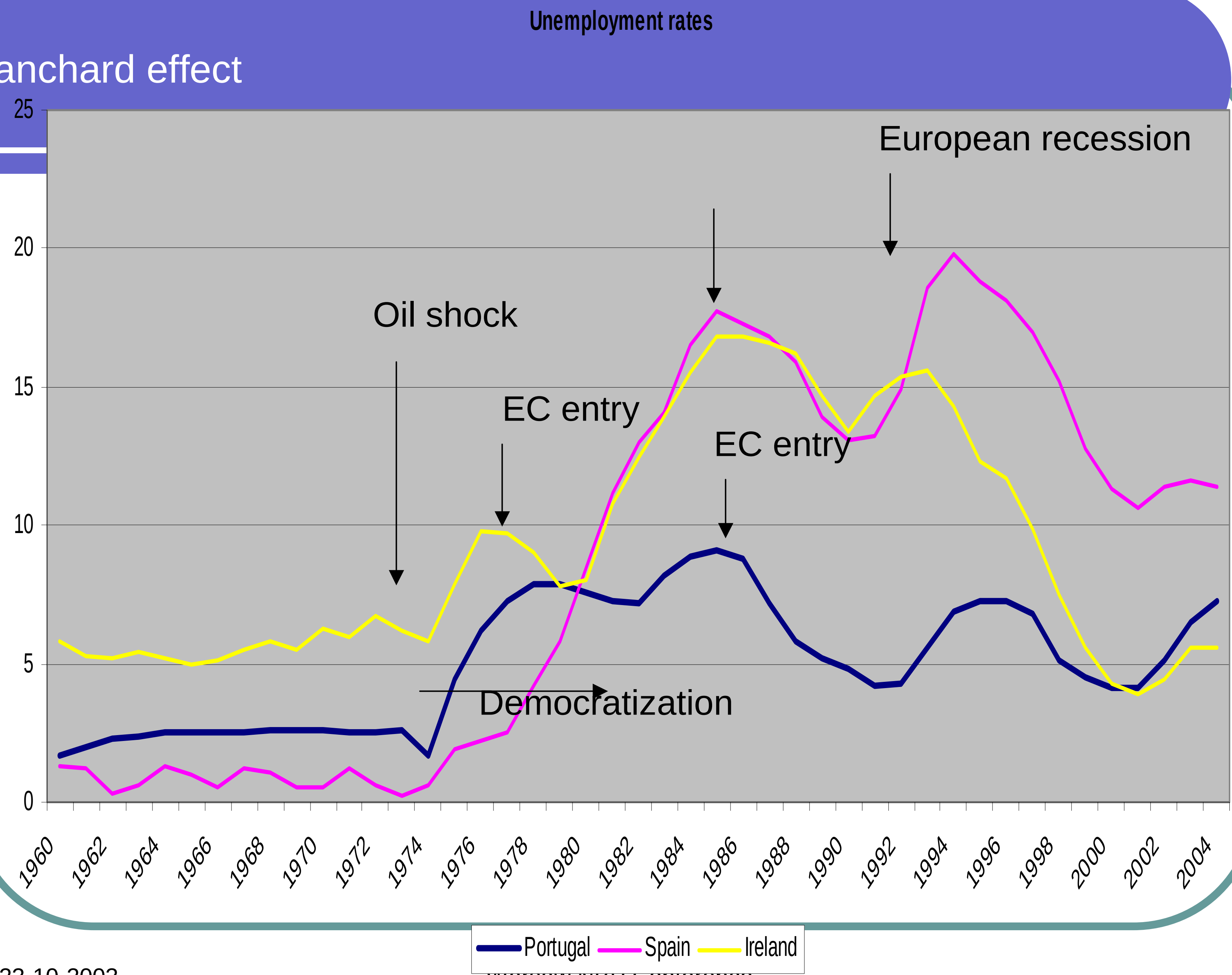
- Democracy is restored, but an initial socialist-military backed regime takes hold
- Nationalization of major enterprises and farms (property rights are challanged)
- External oil shocks
- Internal shocks: wages increased by 70% in 1974-75
- Budget and external deficits of 13% of GDP in 1977 and 1982
- Two IMF stabilization programs

# EC accession and nominal convergence to the euro

- A new majority center-right government takes hold in 1985
- Portugal enters the EC in 1986
- Major program of liberalization and privatization (only second to the UK)
- Fiscal reform (VAT, income tax-maximum rate at 40%)
- Strong growth of physical and human capital
- Balance of payments in surplus
- Inflation still high, but decreasing, with budget deficit also high

- The large undervaluation of the currency coupled with nominal wage flexibility allowed the unemployment rate to stay low, in contrast to Spain and Ireland
- However, industrial restructuring was taking place at a much slower rate

# Blanchard effect



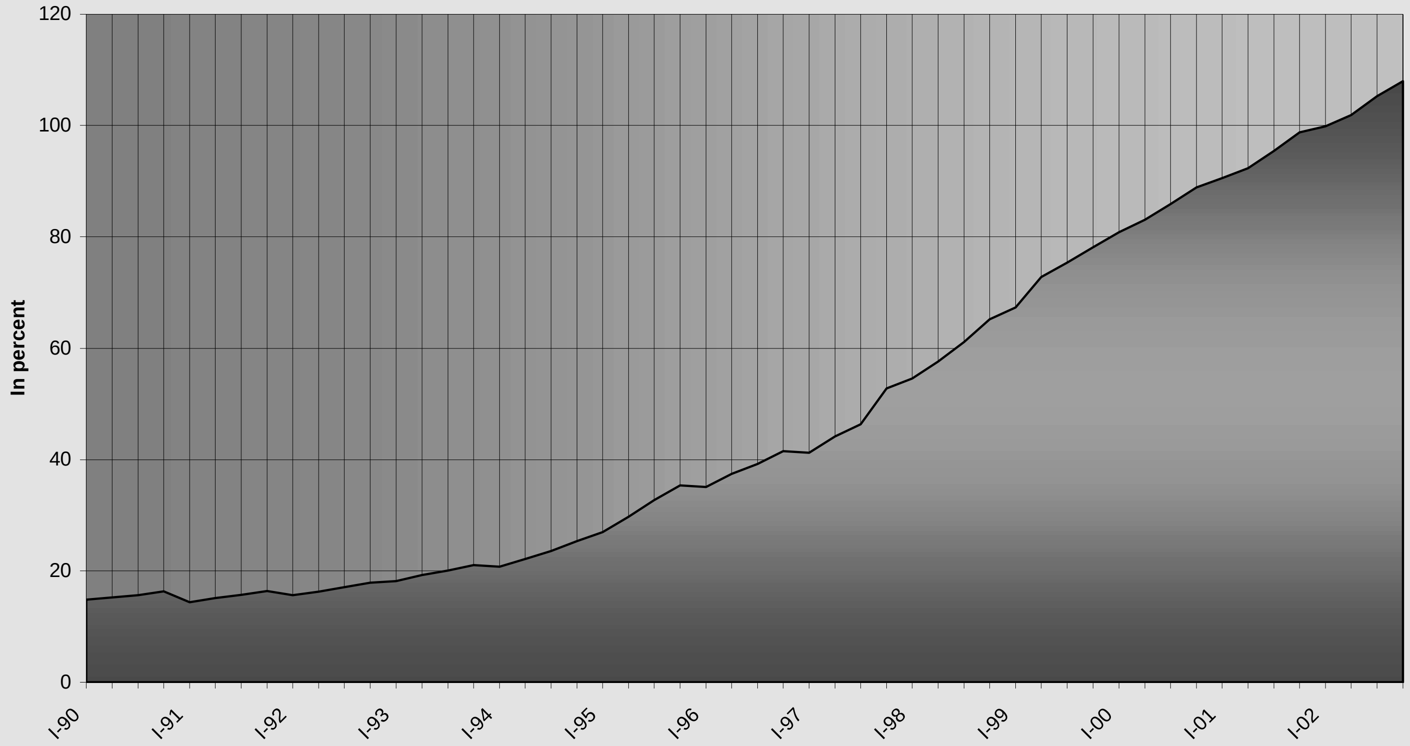
- In 1992-1996 a stabilization program was undertaken to allow convergence to the euro
- Budget deficit decreased gradually (much less than optimal)
- Inflation came down rapidly thru restrictive monetary policy
- In May 1998 Portugal is admitted to the euro
- However, institutional reform slows down


Long-term nominal interest rate
Diferential Port-Germany
6
5
4
3
2
1
0
8-93
12-93
4-94
8-94
12-94
4-95
8-95
12-95
4-96
8-96
12-96
4-97
8-97
12-97
4-98
8-98
12-98

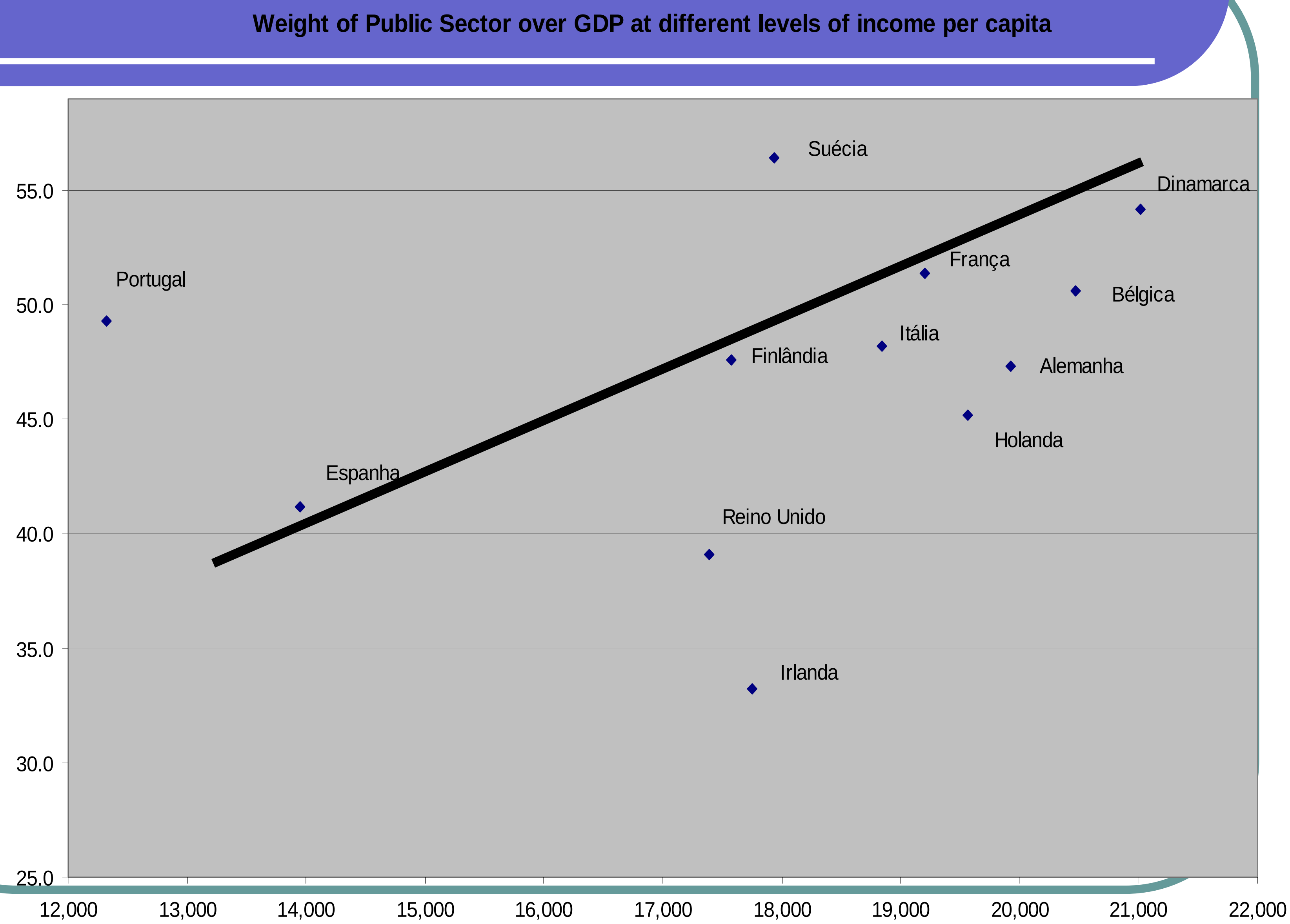
# The present phase of stagnation in the convergence process

- The socialist government of 1995-2002 undertook a populist policy
- Strong increase in public expenditures
- Major public investments of doubtfull returns
- With the decrease in interest rates levels of indebtness of all economic agents explode
- Slowdown in institutional reform continues
  - OECD adice: major rigidities in product and labor markets
  - Need of increasing efficiency of public services

Households: Ratio of total debt to disposable income



# How Portugal compares with OECD countries



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Using the results of the estimation, we compute for each of the previous periods the total contribution of each factor:

| | GDP growth | Physical capital | Human capital | Openness |
|---|---|---|---|---|
| Golden age | 115% | 48% | 28% | 45% |
| Statization | 45% | 25% | 44% | 8% |
| EC accession | 42% | 12% | 17% | 47% |

It is clear from these results that both the golden age period, with EFTA accession, and the EC accession periods were characterized by a strong impact of the openness of the economy

- A model explaining TFP shows that an increase of 1 percentage point in the degree of openness of the economy adds 0.27 to 0.41 points to the increase in the total factor productivity. An increase of 1 percentage point in the M2 velocity adds 0.09 points to the productivity of the economy.
- However, these are level effects. If no institutional change occurs, decreasing marginal returns set-in.

Finally, we estimate the impact of the institutional factors studied above on the total factor productivity. The impact of the EP index on TFP shows that an increase of 1 point in the index translates into an increase of 0.49 percentage points in the productivity growth rate. The following table shows that the improvement in the economic policy index (EP) is an important factor in explaining the large increase in the TFP of the golden age. The slowdown in the TPF during the statization period was also connected to the deterioration in the EP index, as the recovery in TFP of the EC accession period is also related to the improvement in policies and institutions.

| | TFP variation | EP index | Black Market Premium | Banking | Development Policy |
|---|---|---|---|---|---|
| Golden age | 59 | 32 | 5 | 25 | 45 |
| Statization | 6 | -24 | -26 | -27 | -49 |
| EC accession | 17 | 15 | 26 | 19 | 21 |

- Our econometric results show that EU entry added the equivalent to 10% of GDP in the 1986-2000 period
- Estimates consistent with CGE models built for Portugal (Commission, Gaspar and Pereira(1994))
- Portugal and Ireland (high level of transfers) were successful, Greece less so. Spain is a larger country (less relative impact), but also a success case

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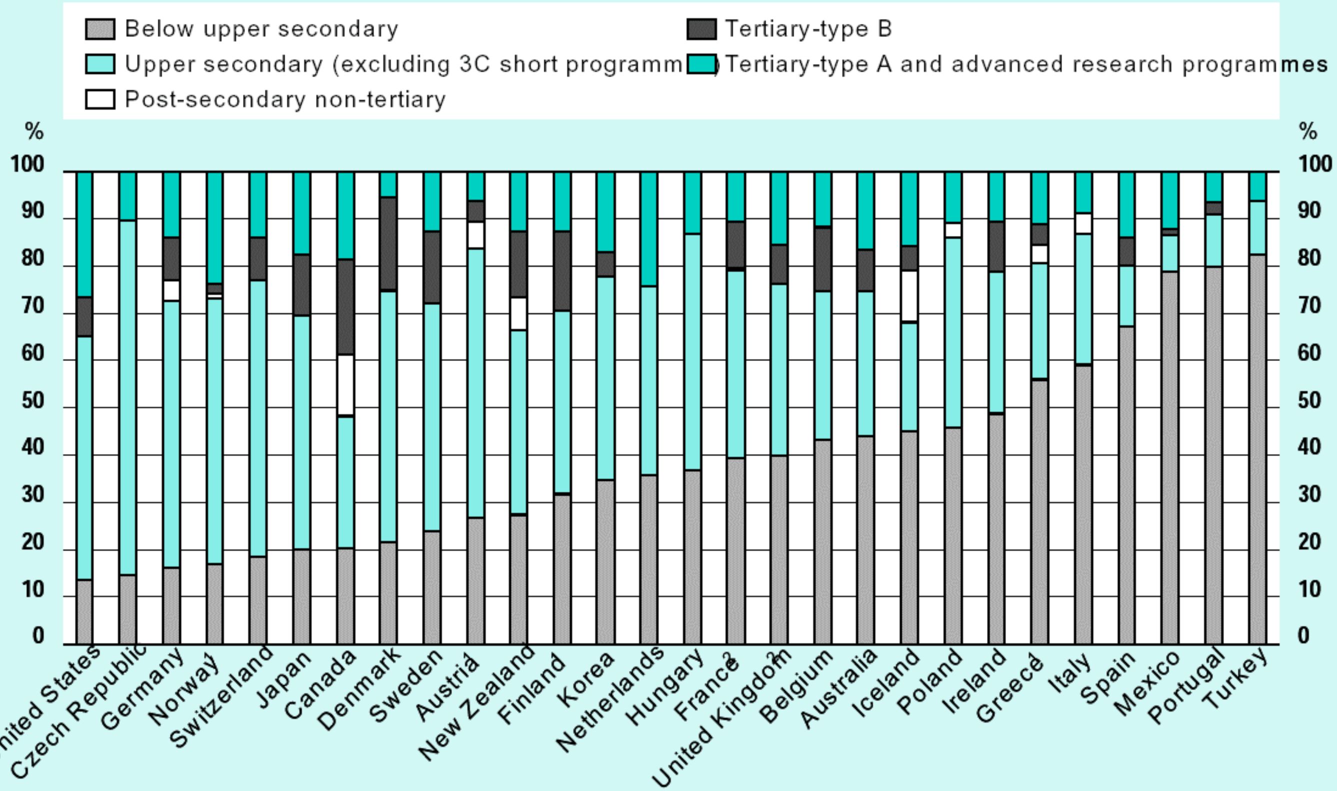
- Compared with Accession Countries:
  - Portugal has about 40% higher income per capita
  - Has a market-based economy with an historical enterpreneurial base
  - Is much more integrated in the European institutions and policy
  - But has less human capital
  - Geography is less favourable: at the periphery

Chart A2.1. **Distribution of the population 25 to 64 years of age by the highest completed level of education (1998)**




1. Year of reference 1997.
2. Not all ISCED 3 programmes meet minimum requirements for ISCED 3C long programmes. For more information see

*Countries are ranked in descending order of the percentage of the population who have completed at least upper secondary education.*

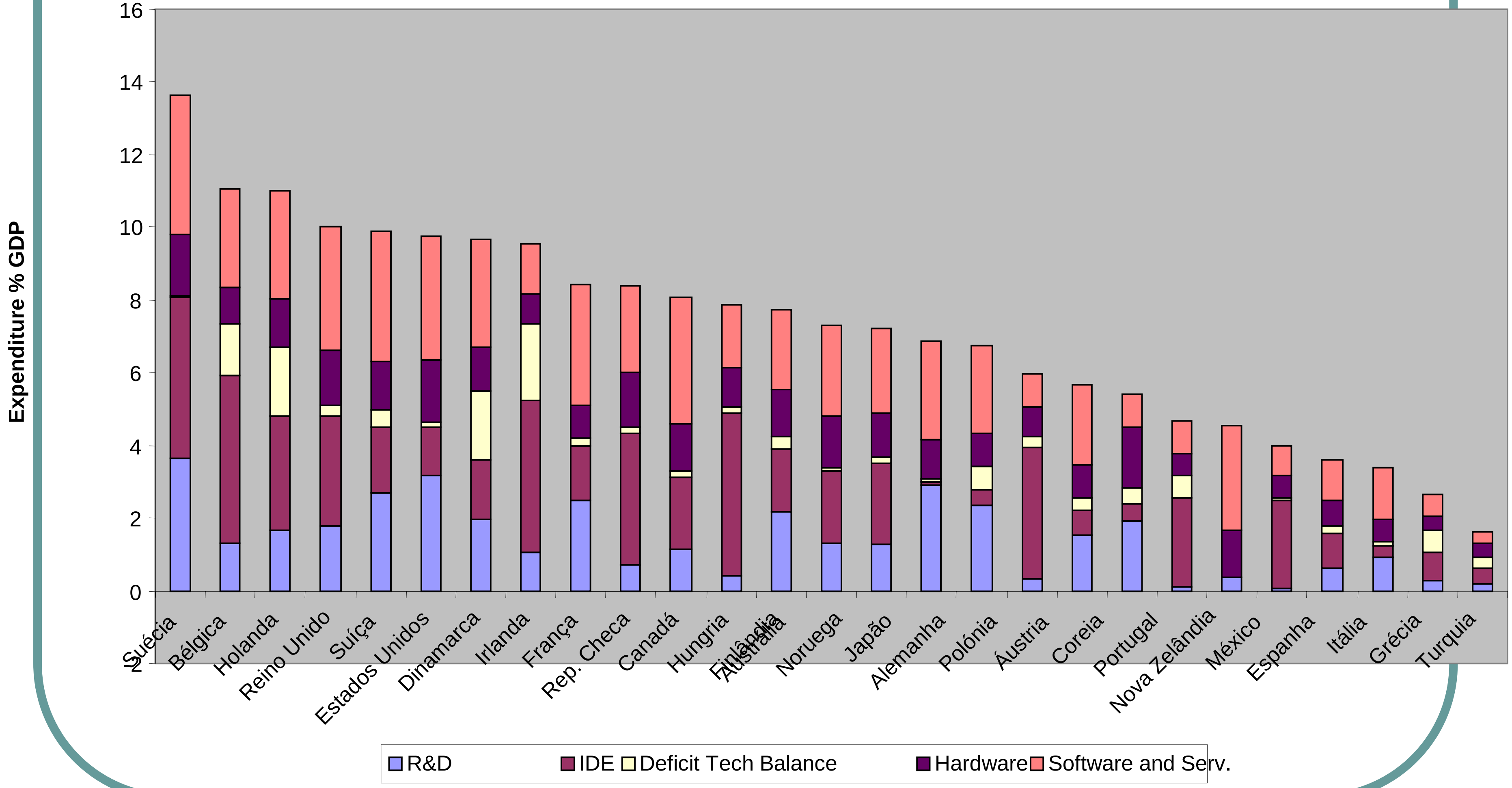
*Source:* OECD.

- In order to jump to reach a level of total convergence, Portugal needs basically two policies:
  - Institutional reform:
    - Increasing labor and product market flexibility
    - Increasing the efficiency of public services coupled with reduction of fiscal pressure
    - Reduce the deficit in the pension system
  - Increase significantly the effort in innovation and technological transfer-development, by
    - Increasing R&D, specially in private firms
    - Continue effort in improving human capital
    - Increase mobility: entry-exit of firms

**OECD Consensus**

## Index of Investment in Innovation and Tech Transfer

Fonte: OCDE, FMI



# Good policies

- Openning up: in trade, investment and technological transfer is crucial
- Building-up human capital and capacity to innovate
- Maintain momentum of institutional reform in all fronts
- Macroeconomic stability is essential (budget balanced and low inflation)

# Bad lessons

- High levels of fund transfers from EU may create aid dependence of some groups and encourage rent seeking of enterpreneurs
- EU funds have improved enourmously the level of physical infrastrucures in Portugal, but after a certain level may lead to mis-spending and decreasing marginal returns
- Without continuous institutional upgrading there is no sustained real convergence

# And finally...

- Nominal convergence needs to be carefully undertaken to avoid the threat of currency and financial crisis (euro accession cannot be rushed)
- Precondition: have an efficient bank supervision system
- **<u>And enter the euro at the correct exchange rate</u>**